ECB: RULES AND A LOT OF DISCRETION

Based on Christine Lagarde's latest press conference, it is clear that the ECB's Governing Council view on the inflation outlook has evolved quite significantly. Since the December meeting, upside risks to inflation have increased, raising unanimous concern within the Council. Financial markets interpreted this as a signal that the first rate hike might come earlier than previously expected and bond yields moved significantly higher. The ECB's forward guidance, which can also be considered as a description of its reaction function, suggests a rule-based approach to setting interest rates with clear conditions in terms of inflation outlook and recent price developments. In reality, a lot of judgment will be used as well. This makes perfect sense given the many uncertainties surrounding the outlook, although it makes the outcome less predictable. With this caveat in mind, we expect a first 25bp rate hike in September, to be followed by a similar increase in December.

For central bankers, a press conference following a monetary policy committee meeting is a balancing act. It is an opportunity to explain the thinking behind the decisions in terms of monetary policy but there is also the risk of saying too much or being misinterpreted. For market participants, these press conferences are, at times, an invaluable source of information, allowing for a better understanding of how policy might evolve. This improves the pricing of financial instruments, also known as the price discovery process.

On this point, last week's press conference of Christine Lagarde provided a perfect example. Markets discovered that the view of the governing council on the inflation outlook has evolved quite significantly in recent weeks. This was already clear from the monetary policy statement with its insistence that since the December meeting, upside risks to inflation have increased[1] and was confirmed during the Q&A with the journalists: *"with the upside surprise that we have seen first in December, second in January, I can tell you that there was unanimous concern around the table of the Governing Council about inflation numbers."* Bund yields jumped as Lagarde spoke, pulling along US Treasury yields (chart 1). The euro strengthened because the more hawkish tone from the ECB implies the prospect of less monetary divergence between the US and the euro area (chart 2). Equity markets declined and, as shown in chart 3, the spread between Italian and German government bond yields widened. The difference between Spanish and German bonds increased as well, albeit to a lesser degree.

Markets will be eagerly awaiting the March meeting with its new set of projections. They will probably see higher inflation for 2022 and possibly for later years as well, although this depends to a large degree on expected wage growth and how it feeds through to consumer price inflation.

1. *"Compared with our expectations in December, risks to the inflation outlook are tilted to the upside, particularly in the near term. If price pressures feed through into higher than anticipated wage rises or the economy returns more quickly to full capacity, inflation could turn out to be higher."* Source: ECB, Press conference of Christine Lagarde, President of the ECB, and Luis de Guindos, Vice-President of the ECB, Frankfurt am Main, 3 February 2022.

A recent ECB survey of major companies operating in the euro area showed that they expect *"average wage increases to move from around 2% in the recent past to 3% or possibly more this year."*[2] The survey also reported ongoing strong or growing demand across most sectors, tighter labour market conditions and a favourable environment in the manufacturing and construction sectors for passing rising input costs through to prices. Morever, the frequency of price increases has increased in order to avoid a squeeze on profit margins.

Clearly, these elements must have played a role in the more hawkish tone of the ECB, in particular considering that since April last year, in every single month with the exception of September, the flash estimate of euro area consumer price inflation has surprised to the upside. Since last summer, these surprises have become bigger (chart 4). The rise in energy price plays a role but it is not the only factor considering that core inflation has also surprised to the upside (chart 5).

2. Source: Main findings from the ECB's recent contacts with non-financial companies, Economic Bulletin Issue 1, 2022, published on 4 February 2022.

INTRADAY (FEBRUARY 3, CET): GERMAN BUND/US TREASURY NOTE

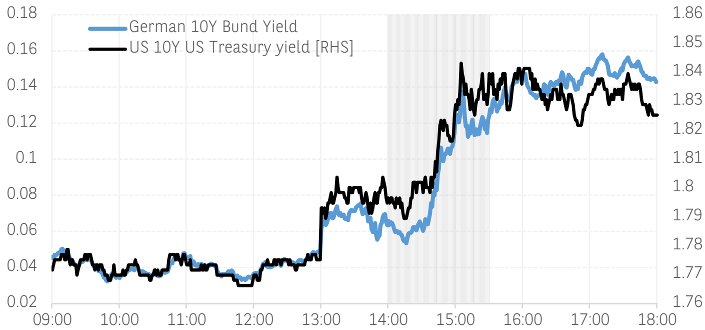

CHART 1

SOURCE: BLOOMBERG, BNP PARIBAS

> The ECB's forward guidance, which can also be considered as a description of its reaction function, suggests a rule-based approach to setting interest rates. In reality, a lot of judgment will be used as well. This makes perfect sense given the many uncertainties surrounding the outlook, although it makes the outcome less predictable.

C. Lagarde insisted during the press conference that the ECB's policy stance is data dependent. Given the recent evolution of the data – rising price pressures, inflation surprising to the upside, faster wage growth – last week's change in message is understandable and even necessary, but what are the implications for the monetary policy outlook? The forward guidance of the ECB states that three conditions need to be met in order to envisage a policy rate hike: inflation at target, i.e. 2%, well ahead of the end of the projection horizon, a conviction that inflation will stay at this level until the end of the projection horizon and sufficiently strong underlying inflation, which would show there is progress towards target. When the data change, the projections may change as well and, eventually, this would end up justifying an increase in official interest rates[3].

This guidance, which can also be considered as the reaction function of the central bank, suggests a rule-based approach to setting interest rates. In reality, a lot of judgment will be used as well. The ECB President insisted, when commenting on the staff projections that *"the determination is made by the Governing Council. Indeed, there is an element of discretionary judgement. We don't take projections just at face value and this is particularly relevant in the current circumstances…"* The combination of rules and a lot of discretion makes sense given the many uncertainties surrounding the outlook, although it makes the outcome less predictable. With this caveat in mind, we expect a first 25bp rate hike in September, to be followed by a similar increase in December.

William De Vijlder

3. It remains to be seen whether, on the occasion of the first rate hike, the ECB governing council would only increase the deposit rate or would increase the refinancing rate as well.

INTRADAY (FEBRUARY 3, CET): EUR/USD

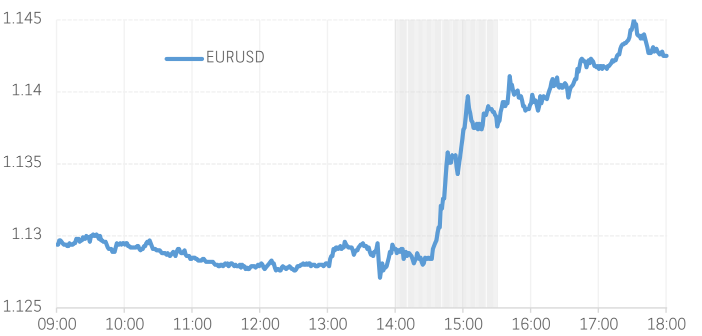

CHART 2 SOURCE: BLOOMBERG, BNP PARIBAS

INTRADAY (FEBRUARY 3, CET): SPREADS BTP-BUND/BONOS-BUND

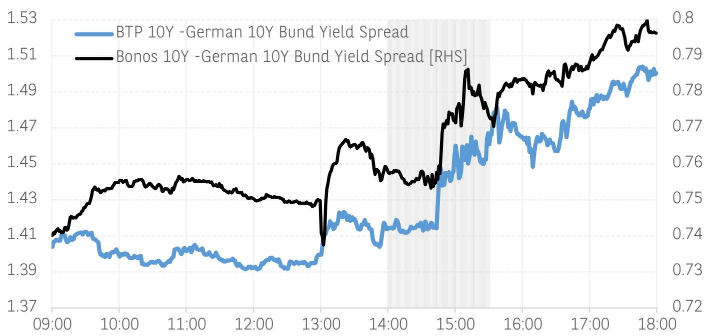

CHART 3 SOURCE: BLOOMBERG, BNP PARIBAS

EUROZONE: FLASH ESTIMATE INFLATION

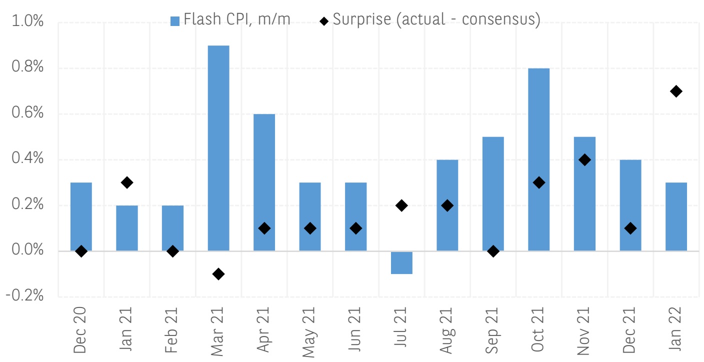

CHART 4 SOURCE: EUROSTAT, BLOOMBERG, BNP PARIBAS

EUROZONE: SURPRISE FLASH

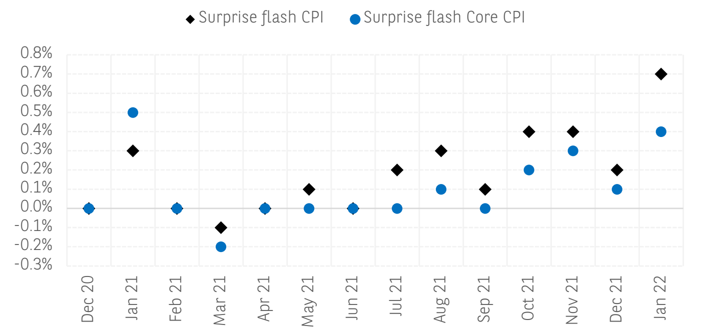

CHART 5 SOURCE: EUROSTAT, BLOOMBERG, BNP PARIBAS